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It is a pleasure to appear before you to discuss the ways in which U.S. tax treaties modify provisions of the Internal Revenue Code of 1954 and to describe the treaty negotiation and ratification process.

The United States currently has 28 income tax treaties in force. Because some of these treaties have been extended to present or former territories of treaty partners, these treaties apply to almost 50 foreign countries and territories. The U.S. tax treaty program dates to the first treaty between the United States and France, which became effective in 1936.

U.S. tax treaties are part of a worldwide network of tax treaties which many countries, particularly developed countries, have with one another. Many of these treaties are based in large measure on the common reference point provided by the model treaties developed by the Organization for Economic Cooperation and Development (OECD). The United States is a member of the OECD, and the model income tax treaty used by the Treasury Department as a starting point in negotiations draws heavily on the most recent OECD model. (However, the OECD model is not binding on the United States or the other OECD participants.)

Purposes of tax treaties.--Tax treaties to which the United States is a party serve two primary purposes: the avoidance of double taxation on the one hand, and the prevention of tax evasion on the other. Although U.S. tax treaties contain many differences in their details, they share certain fundamental approaches to the fulfillment of these purposes.

Double taxation of business income is generally avoided, and the administrative burden on international commerce is reduced, by providing that the income which a resident of one treaty treaty partner earns from sources in the other treaty country cannot be taxed by the source country unless the taxpayer has a "permanent establishment" (usually a branch or office) there. Thus, more than minimal contacts with the source country are required before that country is permitted to impose its tax.

In the case of investment income (e.g., interest and dividends), many countries impose a withholding tax at a flat rate on the gross amount paid to a foreign investor for simplicity in the application and enforcement of the tax. (The United States imposes these taxes at a 30-percent rate.) U.S. tax treaties often avoid double taxation of this income by providing for reciprocal reductions in the rates of (or exemptions from) these withholding taxes.

An additional mechanism through which treaties may provide for the avoidance of double taxation is to provide that the country of the taxpayer's residence will allow some form of credit against its tax for the income taxes which the taxpayer must pay to the other treaty country. Recent U.S. treaties usually provide expressly that certain of the treaty partner's taxes are creditable, but allow the United States flexibility in determining the limits within which a credit will be allowed. Questions have been raised as to whether certain older U.S. tax treaties, which are differently worded, also grant a credit independently of the Code.

If the foregoing methods for alleviating double taxation fail to do so because the tax authorities of the two treaty partners take inconsistent positions on the treaty's application, the treaties provide that the taxpayer may ask the tax authorities of his country to attempt to reach an agreement with the authorities of the other country to resolve the difficulties.

To prevent tax evasion, the treaties authorize the tax authorities of each treaty partner to obtain information relevant to the liability of its taxpayers from the other treaty partner. Treaties also generally provide for assistance in collection by the treaty partners.

Negotiation and ratification.--The process by which tax treaties are negotiated and ratified closely resembles that which applies to other treaties, except that the Treasury Department, rather than the State Department, plays the major role in the Executive branch. A negotiated treaty is transmitted by the President to the Senate for its advice and consent and is there referred to the Foreign Relations Committee.

Reservations to the treaty may be adopted by the Senate, and final passage requires a two-thirds vote. The treaty must also be ratified by the other country involved before the treaty may go into effect. The Ways and Means Committee and the Senate Finance Committee have no role in the ratification process, but they do have jurisdiction over legislation which governs the relationship between treaties and the Code.

I. Modification of the Code by Treaties

It is not the purpose, as such, of U.S. tax treaties to modify Code rules. However, modification of those rules is the necessary consequence of the fulfillment of the treaty's purposes to avoid double taxation and prevent tax evasion. Although the Code itself contains mechanisms to avoid double taxation, these provisions must be general in nature because of the need for them to interact with the widely differing tax regimes of many different countries. The general Code mechanism for the avoidance of double taxation of foreign taxpayers is the general limitation of the tax base to that person's U.S. source income. The general Code mechanism for the avoidance of double taxation on U.S. taxpayers is the foreign tax credit. In any particular case, these mechanisms may provide a poor mesh with a particular foreign country's system. For example, both mechanisms rely heavily on the source of items of income to determine liability. If, under U.S. law, an item of income would be from U.S. sources, while under the law of a foreign country the item would be treated as from sources within that country, double taxation could result. Treaties permit the differing rules of national taxing jurisdiction to be brought into closer correlation, so that income is taxed once, but only once.

Where a Code rule is modified by the United States' agreeing to reduce its tax or to exempt U.S. income received by a foreign investor, the United States usually demands a reciprocal concession by the foreign country to U.S. investors doing business in, or receiving income from, that country. Thus, if a foreign investor would not be taxable on U.S. business income unless he has a permanent establishment here, the United States would also require the treaty to provide that a U.S. investor would not be taxable on business income from the foreign country unless he has a permanent establishment there. Also, withholding rates on investment income are generally reduced reciprocally to the same level, although as to any particular type of income (such as dividends) the foreign treaty country may, under its domestic law, withhold at a rate higher or lower than the 30-percent rate prescribed in the Code.

A. ~~Legal Authority for Modification of Code Rules by Treaties:~~

Constitutional provisions.-- Code rules may be modified by tax treaties because, under the Constitution, both treaties and legislation are the supreme law of the land. U.S. Const., art. VI, cl. 2. Income tax conventions, as U.S. tax treaties are formally named, have been held to be treaties entitled to the protection of the Constitution's supremacy clause. American Trust Co. v. Smyth, 247 F. 2d 149 (9th Cir. 1957); Samann v. Commissioner, 313 F. 2d 461 (4th Cir. 1963).

Treaties and statutes are placed on an equal footing by the Constitution, and thus the rules for resolving conflicts between tax treaties and the U.S. tax laws are the same rules as those which govern conflicts between different statutes on the same subject. Legislative enactments may be overruled by subsequent treaties and treaties may be overriden by subsequent legislation. Whenever possible, treaties and legislation bearing on the same subject are read in a consistent manner. Menominee Tribe v. United States, 391 U.S. 404 (1968); United States v. Payne, 264 U.S. 446 (1924); United States v. Lee Yen Tai, 185 U.S. 212 (1902); Chew Heong v. United States, 112 U.S. 534 (1884); Head Money Cases, 112 U.S. 580 (1884). However, where a statute clearly conflicts with a later treaty, the treaty will prevail. Cook v. United States, 288 U.S. 102 (1933); Lee Yen Tai v. United States, supra. Similarly, a later-enacted statute will prevail over a prior treaty where the conflict is clear. Whitney v. Robertson, 124 U.S. 190 (1888); Head Money Cases, supra; Cherokee Tobacco, 78 U.S. 616 (1870); Taylor v. Morton, 2 Curtis 454 (1855). "Nevertheless, the purpose by statute to abrogate a treaty or any designated part of a treaty, or the purpose by treaty to supersede the whole or a part of an act of Congress, must not be lightly assumed, but must appear clearly and distinctly from the words used in the statute or in the treaty."

Lee Yen Tai v. United States, supra, at 221.

Treaty rules.--In addition, a number of rules exist in both the Code and treaties which generally have the effect of giving the taxpayer a choice between the greater benefits of the Code and the applicable treaty. Thus, Article 1(2) of the current U.S. model income tax treaty provides:

> This Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded--
>
> (a) by the laws of either Contracting State, or
>
> (b) by any other agreement between the Contracting States.

A similar provision is found in most U.S. tax treaties now in force.1/

Because U.S. tax treaties contain a "saving clause" (discussed below) which, with the exception of foreign tax credit provisions, generally allows the United States to tax its own citizens, residents, and corporations as though the treaty had not come into effect, most treaty provisions do not apply to U.S. taxpayers in determining their U.S. tax liability (although these provisions may apply in determining their liability for the treaty partner's taxes).

1/ The treaties with Ireland, Pakistan, the U.S.S.R. and the 1945 treaty (in force as extended to U.K. territories) do not include such a clause.

<u>Code rules</u>.--Additionally, the Internal Revenue Code includes two provisions which are intended to minimize conflicts with tax treaties. Section 7852(d) of the Code provides that:

> No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title.

Thus, it is made clear that the enactment of the Code in 1954 was not to be construed as abrogating prior treaties, apparently in recognition of the rule that the later enacted or ratified otherwise would ordinarily prevail. This provision apparently also protects the benefits of pre-Code treaties against the enactment of subsequent amendments to the Code. Thus, the Revenue Act of 1962 (discussed below) included a specific provision that the Act was to prevail over any conflicting treaties, notwithstanding section 7852(d). However, section 7852(d) does not apply to treaty obligations which went into effect after August 16, 1954, the date of enactment of the 1954 Code.

The second provision in the Code (sec. 894(a)) provides that:

> Income of any kind, to the entent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

This provision applies to all treaties, including those entered into prior to the enactment of the Code amendments which would have required the inclusion of an item of income. However, it does not apply to treaty benefits other than exclusions from income.[2/]

Although both section 894(a) and section 7852(d) broadly affect U.S. treaties, neither appears to have been intended as a comprehensive rule to guide the relationship between treaties and the Code. Section 894(a), while it affects all U.S. tax treaties, applies only to those treaty provisions which require exemption from taxation. Section 7852(d), while applicable to all treaty obligations, applies only to treaties in force at the time of enactment of the Internal Revenue Code of 1954.

2/ Section 894(a) was originally enacted as part of the Revenue Act of 1936 and has been reenacted since. The original reason for enactment was to prevent the Revenue Act of 1936 from overriding the provisions of the tax treaty which had previously been entered into with France, Revenue Act, 1936: Hearings on H.R. 12395, Before Senate Committee on Finance, 74th Cong., 2d Sess. 43 (1936).

The Congress on other occasions has considered the relationship between treaties and Code amendments and, in at least one instance, has overridden a treaty by legislation. Thus, it was pointed out in hearings on the Revenue Act of 1962 that a number of provisions of the bill might conflict with U.S. tax treaties and that, under section 7852(d) of the Code, certain treaties would takepriority over the bill. Among the provisions said to be affected were rules for including currently the tax haven income of controlled foreign corporations in the income of the U.S. shareholders; a rule for "grossing up" dividends received from foreign subsidiaries in connection with computing the foreign tax credit on the dividends; and a rule including in the estates of U.S. decedents their foreign real estate holdings. The Ways and Means Committee added a provision to the bill which stated that the amendments made by the bill would prevail over conflicting treaties. The Senate Finance Committee deleted this provision and substituted a new rule expressly stating that no provision of the bill would apply if it conflicted with any treaty obligation of the United States. In conference, the House position prevailed (sec. 31 of the Act). The only conflict with treaties which the Treasury determined to exist was in the real estate provisions of the Greek estate tax treaty. 3/ That treaty was promptly renegotiated to remove the conflict.

3/ It has been argued that the provisions of the 1962 Act involved a considerably greater conflict with treaties then in force. See Beemer, "Revenue Act of 1962 and United States Treaty Obligations," 10 Tax L. Rev. 125 (1964).

The question of the relation between the treaties and the Code arose again under the Foreign Investors Tax Act of 1966. The Act (sec. 110) provided that no amendment made by the Act was to apply in any case where its application would be contrary to any treaty obligation of the United States. However, the granting of a benefit provided by any amendment made by the Act was not considered to be contrary to a treaty obligation and thus would be available.

The rule providing that a provision of the Act which granted a benefit could prevail over treaties laid the foundation for a provision in the Act which in effect rewrote U.S. tax treaties then in force. Prior to the 1966 Act, the United States taxed foreign investors under the "force of attraction" principle. Investors who were not engaged in business in the United States were generally taxed at a flat 30 percent rate on gross income (or, if higher, at graduated rates on net income). If the investor was engaged in a U.S. business, however, he was taxed at graduated rates on all his net income from U.S. sources, even his U.S. income which was not connected with the business and which would have been taxed at flat rates had he not been engaged in business. U.S. treaties were written with this regime in mind. For example, the Austrian treaty provides that industrial and commercial profits of an Austrian enterprise will not be subject to tax unless the enterprise has a U.S. permanent establishment, but, if it does, the U.S. may impose its tax on all the U.S. source income of the Austrian enterprise, also, exemptions from, or reductions in, tax on various types of passive income apply only if the taxpayer does not have a U.S. permanent establishment. However, as described earlier, the 1966 Act generally changes U.S. taxation principles so that income effectively connected with a U.S. business is taxed at graduated rates, while investment income which is not connected is taxed at a flat 30-percent rate regardless of whether or not the taxpayer also has a U.S. business. Section 894(b) of the Code, added by the 1966 Act, in effect amends all the earlier U.S. tax treaties to incorporate this new principle. That section provides that, if a treaty would reduce or eliminate U.S tax on income if the taxpayer did not have a U.S. permanent establishment, then he will be treated as not having a permanent establishment with regard to income which is not connected with a U.S. business. This income could therefore qualify for the treaty benefits. Thus, by legislation, the "force of attraction" principle was read out of U.S. tax treaties in situations where such a reading would benefit taxpayers (which generally would be the case).

The 1966 Act also dealt with the relation between treaties and the Code in another way which, although it also did not deprive taxpayers of treaty benefits, did deprive them of certain Code benefits if a treaty exemption or reduction applied to the income. The 1962 Act had added certain provisions to the Code (subpart F) which required U.S. shareholders of a controlled foreign corporation (CFC) to include in their income their share of certain "tax haven" income of the CFC as though it had been distributed to them as a dividend. An exception was made to this rule if the "tax haven" income was effectively connected with a U.S. business. However, the 1966 Act restricted this exception so that it was unavailable where the U.S. income was subject to exemption or a reduced rate of tax under a treaty. (Code sec. 953(b)).

The Tax Reduction Act of 1975 and the Tax Reform Act of 1976 made a number of changes to the rules governing the computation of the foreign tax credit (in particular, they eliminated the option to compute the credit on a per-country basis and required that the overall limitation be used in all cases). Although it is not at all clear to what extent Code rules as changed by these Acts conflicted with any U.S. treaty obligations, the changes overrode any treaty provisions to the extent they were inconsistent. The <u>General Explanation of the Tax Reform Act of 1976</u>, in its discussion of the changes made by that Act to the foreign tax credit rules, states:

> The Congress further intends that, as is the case with other recent legislation modifying the foreign tax credit, the changes made by the Act are to be used in computing the credit allowed under all treaties.

Materially identical language appears in the committee reports on the Act.[4/]

4/H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 226(1975); and S. Rep. No. 94-938, 94th Cong., 2d Sess. 237(1976).

Recently, the conferees on the Crude Oil Windfall Profit Tax Act of 1980 stated in their report that they were unaware of any U.S. treaty obligations which would conflict with the Act but, if there were such a conflict, the conferees intended that the legislation prevail. H.R. Rep. No. 96-817, 96th Cong., 2d Sess. 106 (1980). Also, three bills reported in December 1979 by the Senate Finance Committee which would tax real property gains realized by foreign investors, H.R. 1212, H.R. 1319, and H.R. 2297, each provide that any conflicting U.S. treaty obligations would prevail over the legislation for five years, after which the legislation would take precedence over the conflicting treaties.

B. Modification of Code Rules: Foreign Taxpayers

Many treaty rules, while reciprocal in form, affect U.S. tax liability only for foreign taxpayers. As noted earlier, the "saving clause" in U.S. treaties generally withholds the benefits of these provisions from U.S. taxpayers in determining their U.S. tax liability. (In the case of U.S. taxpayers, the primary impact of the treaties is in modifying their tax liability to the treaty partner.) However, these treaty provisions do have an important effect on the rules affecting U.S. taxation of foreign investors. In general, the treaty rules require a more significant presence in the United States before a foreign investor may be taxed on his active business income. In the case of passive investment income, the treaties frequently reduce or eliminate U.S. withholding taxes.

Active business income.--Under the Code, income from U.S. sources is subject to tax at the graduated rates which apply to U.S. domestic taxpayers if the income is effectively connected with the conduct of a trade or business within the United States. (However, the taxpayer's foreign income which is not subject to U.S. tax is not taken into account in determining the applicable rates of tax.) In addition, certain foreign source income may also be subject to tax if, for example, it is attributable to a U.S. office of the taxpayer.

U.S. treaties generally provide, however, that the business profits (sometimes the treaties refer to industrial or commercial profits) of a foreign taxpayer are not taxable by the United States unless they are attributable to a "permanent establishment" within the United States. The definition of "permanent establishment" varies from treaty to treaty but generally would include, for example, an office, branch, or factory. It is possible to be engaged in a U.S. trade or business, but not to have a U.S. permanent establishment. This was the case, for example, in Inez de Amodio, 34 T.C. 894 (1960), where a foreign individual owned income-producing real property in the United States and managed it through independent real estate agents.

Personal services.-- Generally, under the Code, income from the performance of personal services within the United States is subject to tax at the graduated rates which apply to U.S. domestic taxpayers. A *de minimis* exception is made where the taxpayer is in the United States for 90 days or less during the taxable year, works in behalf of a foreign employer not engaged in a U.S. business, and is paid no more than $3,000 for the U.S. services. Under the more recent treaties, individuals performing independent personal services are generally taxable only if the earnings are attributable to a "fixed base" they maintain in the United States or the individual is present in the United States more than 183 days during the taxable year. Employees generally are not taxable if they are in the United States 183 days or less in the taxable year and are paid by a foreign employer, if the expense is not borne by a U.S. permanent establishment or fixed base of the employer. Thus, in the case of an employee, a greater U.S. presence by both the employer and the employee is required, and generally there is no dollar limitation on the compensation received.

In addition, many treaties provide special rules for students, trainees, teachers, artists and atheletes.

Investment income.--Periodic investment income (e.g., dividends, interest, rents, royalties) not connected with a U.S. business is generally subject under the Code to tax at a flat rate of 30 percent on the gross amount of the income (i.e., without the allcwance of deductions for expenses incurred to produce the income). Capital gains not connected with a U.S. business are not subject to tax except in the case of a nonresident alien who is present in the United States 183 days or more during the taxable year.

In some cases, the expenses of producing investment income may be considerable. This is particularly true in the case of rental income from improved real estate. The Code permits a foreign investor an irrevocable election to treat his U.S. real estate income as though it were connected with a U.S. business. This allows him to pay tax at the usual graduated rates on that income net of deductions, but it also requires him to pay tax on the gain recognized on sale of the property. The expenses of earning other types of passive income may also be significant, *e.g.*, dividends paid by stock bought on margin will have associated interest deductions. However, the Code has no rule permitting deductions to be taken in these cases.

U.S. tax treaties generally deal with the possibility of double taxation by retaining the concept of a flat tax enforced through withholding at the source on passive investment income, but reducing the rate. Thus, for example, while many U.S. treaties retain a 30-percent rate of tax on interest, interest generally is exempt under treaties with Austria, Denmark, Finland, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, Malawi, Netherlands, Netherlands Antilles, Norway, Poland, Sweden, U.S.S.R., United Kingdom, and Zambia. Reciprocal reductions in rate are provided under treaties with Belgium, Burundi, Canada, Rwanda, and Zaire (15 percent), Korea (12 percent) France, Japan, and Romania (10 percent) and Switzerland (5 percent).

The rate on dividends is generally reduced to 15 percent under the treaties, and further reductions to 10 or 5 percent are often applicable to dividends paid to a parent corporation. Royalties are generally exempt from tax, and the rate on real property income is often reduced to 15 percent.

Most U.S. treaties do not contain provisions relating to capital gains, in part because these gains generally are not subject to tax by the source country. However, more recent U.S. treaties generally follow the OECD model in exempting capital gains which are not from real estate or from property of a permanent establishment or fixed base.

Shipping income.--The Code provides that foreign ship owners are exempt from U.S. tax on U.S. source shipping income as long as the income is derived from the operation of a ship documented under the laws of a foreign country which grants an equivalent exemption for the shipping income of (or imposes no tax on the income of) citizens and corporations of the United States. The determination that a foreign country grants an equivalent exemption is usually made by an exchange of notes between the two countries. Even in those cases where a reciprocal exemption under the Code or a treaty is not in effect, relatively little tax is imposed on the international shipping profits of foreign corproations since the present source rules for shipping income treat only a relatively small portion of the total international shipping income as from U.S. sources.

U.S. tax treaties also generally provide for a reciprocal exemption which would exempt shipping from taxation by either country even if there were no statutory exemption. (Although there is substantial overlap, the scope of the treaty reciprocal exemption is somewhat different than the statutory reciprocal exemption.) These treaties are in effect with virtually all of the developed countries and with most of the significant maritime countries of the world, including the United Kingdom, Germany, France, Japan, Norway, Greece, and the Soviet Union.

C. Modification of Code Rules: U.S. Taxpayers

As previously noted, the "saving clause" in U.S. tax treaties makes many treaty provisions inapplicable to U.S. citizens, residents, and corporations. However, treaty provisions dealing with the allowance of a foreign tax credit generally are not subject to the saving clause.

All U.S. tax treaties (except the treaty with the U.S.S.R.) have a provision dealing with the allowance of a foreign tax credit. The United States agrees to include these provisions not to benefit U.S. taxpayers, but because the foreign treaty partner seeks assurances that the income taxes which it imposes will not result in double taxation of U.S. businesses investing within its borders. Such double taxation would impede U.S. investment in the foreign country, whereas U.S. treaty partners generally would prefer to encourage that investment.

Similarly, the United States seeks assurances that the foreign treaty partner will grant a foreign tax credit for U.S. income taxes so that enterprises of the foreign country will not be discouraged from investing in the United States.

Treaty credit articles modify applicable Code rules in a number of ways. The most significant aspect of the more recent U.S. treaties is that they clearly provide that certain foreign income taxes covered by the treaty will be treated as creditable income taxes for purposes of the Code. Thus, for example, the recently ratified treaty with the United Kingdom provides that the U.K. Petroleum Revenue Tax ("PRT") will be treated as a creditable income tax. (However, this provision is subject to a special limitation to prevent the treaty benefits from being used to offset U.S. tax liability on foreign income other than U.K. source income subject to the PRT.) U.S. taxpayers may use this provision to claim a credit for the PRT even though the IRS has ruled that, in the absence of the treaty, the PRT would not be a creditable income tax. (Rev. Rul. 78-424, 1978-2 Cum. Bull. 197.)

The wording of the credit articles in older U.S. treaties generally differs from that in the newer treaties. As a result, there is some disagreement as to whether these older treaties also provide a foreign tax credit for covered taxes indepentently of the Code requirements. There have been no court cases on this point. Many of the interpretations of the Treasury, IRS, and Congressional committees are ambiguous on this issue and in most cases it appears that the authors were not focusing on it.

Some U.S. treaties also prescribe detailed rules for determining the country of source of various items of income. While these generally parallel the Code source rules, to the extent that there are differences, the allowable foreign tax credit may be affected. This is because the allowable credit is limited to an amount equal to the U.S. tax on the taxpayer's foreign-source income. An increase in income attributed to foreign sources could thus increase the allowable foreign tax credit. (These source-rule modifications may also be relevant in determining the amount of income of a foreign taxpayer which is subject to U.S. tax.)

Some older U.S. tax treaties may also affect the manner in which this limitation on the foreign tax credit is computed. The tendency in more recent treaties, however, has been to avoid placing restrictions on the computation method which the United States may use by amending the Code from time to time, so long as the method does not change the general principle of the treaty credit article. Thus, for example, under the more recent treaties the United States may continue to compute the limitation on an "overall" basis, averaging the taxes and foreign income from all overseas operation, or, if the Code were amended, it may revert to the "per country" limitation, under which the limit is applied on a country-by-country basis. (The per-country method has been optional or mandatory in the past.)

D. Administrative Provisions

Mutual agreement.--Sometimes the United States and the other partner to a tax treaty may apply their laws and the treaty in a manner which still results in double taxation of the same income because of inconsistent positions of the treaty partners. By far the most important example of a situation of this type is the reallocation of income between related parties (or between a corporation organized in one country and its branch in the other). For example, suppose a U.S. parent corporation sells partially assembled goods to a subsidiary corporation in a treaty country. The subsidiary then finishes the assembly and sells the goods to unrelated purchasers. The IRS may assert that the U.S. parent, had it been dealing with the subsidiary at arm's length, would have charged more for the goods. The IRS may make an adjustment increasing the parent's income to reflect the amount which should have been received. (This adjustment may be made under section 482 of the Code. Treaties also generally provide that, for purposes of applying their provisions, adjustments may be made between related enterprises so that the profits of each include profits which would have been earned had they dealt with each other independently.) Such an adjustment increasing the amount deemed received by the parent should call for a correlative adjustment increasing the amount deemed paid by the subsidiary. This would, of course, decrease the subsidiary's income. However, the tax authorities of the foreign treaty partner may not agree that the subsidiary paid too little for the goods. If they fail to make the correlative adjustment reducing the subsidiary's income, then the subsidiary is taxed by the treaty partner, and the parent is taxed by the United States, on the same income.

In situations such as this, the taxpayers may request that the tax authorities of the two countries attempt to reach an agreement between themselves as to the correct liabilities of the taxpayers. In the case of the United States, this function is under the jurisdiction of the IRS Assistant Commissioner (Compliance). Frequently, the result of consideration under this procedure will be reduction or elimination of the adjustment which the IRS had proposed to make in the taxpayer's income subject to U.S. tax.

Tax treaties also permit the tax authorities of the two countries to exercise certain other functions. For example, many treaties expressly provide that the tax authorities may establish a common meaning for undefined treaty terms, particularly where those terms have different meanings under the domestic laws of the two treaty partners.

Exchange of information.--U.S. tax treaties also generally provide for the exchange of information between the tax authorities of the treaty partners. This exchange is generally of two types. First, there may be routine information reporting to the treaty partner. For example, U.S. law generally provides that the payor of interest is required to file an information return with the IRS. If the return shows that the recipient is in a treaty country, the IRS frequently will pass along this information to the treaty partner. Similarly, the IRS receives information returns from a number of foreign countries. Questions have been raised, however, as to whether these documents are in a form which enables them to be utilized effectively by the IRS. Moreover, some tax haven countries take the position that they do not have the resources to provide routine information exchanges.

In addition, tax authorities of one country may request specific information from the other relating to a particular taxpayer. A request for information by Canada under the U.S.-Canada treaty was upheld in United States v. A.L. Burbank & Co., 525 F.2d 9 (2d Cir. 1975), cert. denied, 426 U.S. 934 (1976), even though only Canadian, and not U.S., tax liability was at issue.

The treaties generally provide that information may not be obtained except in accordance with the domestic laws of the treaty partners. Thus, enforcement of an IRS summons was recently refused where the IRS was attempting to obtain information for Norway and the U.S. government failed to show that Norway could obtain information under its domestic law in similar circumstances.

United States v. Lincoln First Bank, 80-1 U.S.T.C. ¶9231 (S.D.N.Y. 1980). Also, the information may only be used by tax officials and generally is to be kept secret, although it may be admitted in judicial proceedings.

It is considerably more difficult to obtain information under some treaties than others. For example, under the treaty with Switzerland, certain information may be obtained only to prevent "fraud or the like." The Swiss concept of tax fraud is considerably narrower than the U.S. concept. Moreover, Swiss law provides only limited power to tax officials to require the production of documents. Since the Swiss need not provide information which cannot be obtained under their domestic law, this too limits the information which the United States may obtain.

E. Estate and Gift Tax Treaties

The United States currently has estate tax treaties with 13 foreign countries. Treaties relating to gift taxes are in effect with three of these countries. These treaties generally serve functions with respect to estate and gift taxes which are similar to the functions served by income tax treaties. They are also negotiated and ratified pursuant to the same procedures as income tax treaties.

In general, these treaties permit only one of the two treaty partners to impose its tax on property in situations where, under the domestic laws of the treaty partners, both might claim taxing jurisdiction. If the country which may not impose its tax on a particular property under the treaty taxes on a worldwide basis (as is the case with the United States), it generally is required to give a credit against its tax for the tax imposed on that property by the other treaty partner.

Usually, the country of the taxpayer's domicile is given the exclusive right to tax under the treaty, but in some cases (e.g., real property), the country of situs has the exclusive right. Where both countries would, under their domestic law, treat the taxpayer as a domiciliary, the treaties provide rules to establish one of the two treaty partners as the country of domicile.

Like income tax treaties, these treaties provide mutual agreement procedures and rules for the exchange of information.

F. Social Security Totalization Agreements

Although not strictly "treaties," another form of international agreement affecting tax liabilites is the Social Security "totalization" agreement authorized by section 317 of the Social Security Amendments of 1977. The United States thus far has concluded totalization agreements with Italy, West Germany and Switzerland. The law authorizing these agreements prescribed certain provisions which they must contain. In general, periods of coverage under the social security systems of the United States and the other country involved are aggregated to determine qualification for benefits and dual coverage for the same employment is eliminated. Benefits payable under U.S. Social Security on the totalized credits are prorated based on the proportion of periods of coverage under the U.S. system to total coverage. The individual involved is exempted from paying social security taxes to one country while he is required under the agreement to pay them to the other country.

These agreements are referred to Congress and go into effect unless either House adopts a resolution of disapproval. In the House, they are referred to the Ways and Means Committee; in the Senate, they are referred jointly to the Foreign Relations and Finance Committees.

II. Steps in the Negotiation and Ratification of Tax Treaties

Negotiators.--Tax treaties (and protocols to existing tax treaties) are negotiated by the Office of International Tax Affairs of the Treasury Department with the assistance of Internal Revenue Service personnel. Ordinarily, the involvement of the State Department at the negotiator's level is only peripheral, although the law requires that the State Department be consulted prior to the signing of any treaty. Foreign negotiators ordinarily are representatives of the foreign tax authorities.

Model treaties.--U.S. negotiators start from the U.S. model income tax treaty (or, in the case of an estate and gift tax treaty, the U.S. model estate and gift tax treaty), which is a public document prepared by the Treasury Department setting out the preferred U.S. position on each article. The model income and estate tax treaties of the Organization for Economic Cooperation and Development (the OECD) also are used as guides.

Other precedents.--The Treasury generally will also take into account recent expressions of Senate views on matters covered by other treaties. For example, the Senate refused to agree to the recently ratified treaty with the United Kingdom until a provision which would have restricted the taxing authority of the States was deleted. France thereafter asked that a similar provision be included in a protocol to its treaty with the United States. The U.S. negotiators made it clear, however, that they could not agree to such a provision in light of the Senate's action on the U.K. treaty. Similarly, the Treasury will not agree to "tax sparing" provisions in treaties with developing countries because of the Senate's rejection of such provision in treaties before it in prior years.

Public comments to Treasury.--Treasury announces that it intends to negotiate a treaty with a particular foreign country or renegotiate an existing treaty, and this gives interested parties an opportunity to comment. Also, Treasury has recently introduced a policy of having public sessions after negotiations have made substantial progress at which it outlines the issues involved in the treaty and the possible solutions (but not the specific terms of draft language) and solicits the views of interested parties.

Initialling of treaty text.--After the text of the treaty is agreed to, it is initialled by the negotiators. The initialling is not of a binding nature but merely serves to identify the text agreed upon at the negotiator's level. Textual changes may be made after the draft is initialled.

Signing of treaty.--After an official translation of the text is completed and the text is approved for form by the State Department, it then is signed by the appropriate officials of each government. (In the case of the United States, this is ordinarily the Secretary of State or the U.S. Ambassador to the foreign country.) After signature, Treasury publicly releases the treaty text.

Letter of transmittal.--The treaty is then sent to the White House for signature by the President of the letter of transmittal to the Senate requesting approval of the Senate to ratification by the President.

Senate Committee on Foreign Relations.--The tax treaty is referred by the Senate to the Committee on Foreign Relations, which conducts hearings on it. After the committee's deliberations it may report the treaty to the Senate floor with the recommendation that the treaty be approved as negotiated, or that the Senate approve the treaty with certain amendments, reservations, or understandings. The committee may also decline to report the treaty favorably.

The Foreign Relations Committee and its staff is assisted in its consideration of the treaties by the staff of the Joint Committee on Taxation. The Joint Committee staff generally prepares explanations of the terms of the treaty and, where possible, background information on the reasons for which provisions were incorporated in treaties, particularly where these provisions have not been incorporated in prior treaties.

The staff also presents testimony on these matters and answers Senators' questions. Staff assists in the preparation of committee reports on the treaties by providing explanations of the operation of their provisions. In general, this assistance is of the same type which the staff provides to the tax-writing committees.

Senate deliberation.--Following committee action, the treaty is reported to the full Senate which must advise and consent to its ratification by a vote of two-thirds of the Members present. Individual Senators may offer amendments, reservations, or understandings after the Senate has acted upon any amendments, reservations, or understandings proposed by the Committee on Foreign Relations. Any votes to be taken by the Senate on any amendments, reservations, or understandings require a majority with the exception of a motion to table the proposed tax treaty, which requires a two-thirds vote.

Ratification.--If the treaty is approved without reservation or amendment, the President may then exchange instruments of ratification with the foreign government (assuming the foreign government has also completed its internal procedures which must be carried out before it can ratify the treaty).

Revision of existing treaties.--Where it is determined that changes to an existing tax treaty would be appropriate because the treaty is outdated in certain respects (for example, where there have been changes in the tax laws of either country since the existing treaty was negotiated), the changes may be made by revising the treaty with a protocol. Where, however, the changes are substantial enough, a new treaty may be negotiated to replace the existing treaty.

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